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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact: _____, ID No. _____

Telephone Number:

Refer Reply To:
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PLR-139483-14

Date:
March 16, 2015

In Re:

Legend:

Settlor	=
Spouse	=
Daughter	=
Son	=
Grandson	=
Granddaughter 1	=
Granddaughter 2	=
Trust	=
Trust A	=
Trust B	
Grandson's Trust	=
Granddaughter 1's Trust	=
Granddaughter 2's Trust	=
State	=
State Statute	=
X	=
Certificates 1 and 2	=
Certificates 3 and 4	=
Date 1	=

Date 2 =
Date 3 =

Dear :

This letter responds to your letter dated October 20, 2014, submitted by your authorized representative requesting income, gift, and generation-skipping transfer (GST) tax rulings with respect to the proposed conversion of an income-only trust to a total return unitrust pursuant to State Statute.

Settlor established an irrevocable trust (Trust) on Date 1 (a date prior to September 25, 1985) for the benefit of his two children, Daughter and Son, and their issue. Paragraph 2 of Trust provides that the trustee shall place shares of X evidenced by certificates 1 and 2 in Trust A, and shares of X evidenced by certificates 3 and 4 in Trust B.

Paragraph 3 provides that during the life of Daughter, the trustee may from time to time pay to, or apply for the benefit of, any one or more of the group consisting of Daughter and Daughter's issue who are living from time to time such amount or amounts of the net income of Trust A as the trustee in its uncontrolled discretion may determine. Any net income in any year which is not paid to or applied for the benefit of any one or more of said group shall be added to the principal of Trust A at the end of each year. In addition, the trustee may pay to or apply for the benefit of any one or more of said group from the principal of Trust A from time to time such amount or amounts as the trustee in its uncontrolled discretion may determine.

Paragraph 5 provides that upon Daughter's death, if she has no issue then living, the remaining principal and undistributed income of Trust A shall be distributed to the Settlor's then living issue, *per stirpes*.

Paragraph 6 provides that if Daughter has issue living at the time of her death, the trustee shall ascertain the total amount in a fund comprised of (a) the then remaining principal and undistributed income of Trust A, plus (b) payments made to Daughter's issue under paragraph 3 hereof and minus (c) the payments made to a deceased child of Daughter and to such deceased child's issue under paragraph 3 hereof if such deceased child has no issue then living. The trustee shall divide such fund into as many equal shares as there are (a) children of Daughter then living, and (b) children of Daughter then deceased with issue then living. The trustee shall allocate to each living child of Daughter, out of the remaining principal and undistributed income of Trust A, an amount equal to one of such equal shares minus the payments made to such child and to such child's issue under paragraph 3 hereof, and the trustee shall hold such amount in a separate trust in accordance with the provisions of paragraph 7 hereof.

Paragraph 7 provides that a separate trust for each living child of Daughter is as follows. Paragraph 7(a) provides that during the life of such child prior to the termination of the trust pursuant to paragraph 11 hereof the trustee may from time to time pay to, or apply for the benefit of, any one or more of the group consisting of such child and such child's issue who are living from time to time such amount or amounts of the net income as the trustee in its uncontrolled discretion may determine. Any net income in any year which is not paid to or applied for the benefit of any one or more of that group shall be added to the principal at the end of each year. In addition, the trustee may pay to or apply for the benefit of any one or more of that group from the principal of the separate trust estate from time to time such amount or amounts as the trustee in its uncontrolled discretion may determine.

Paragraph 7(b) provides that upon the termination of the trust pursuant to paragraph 11 hereof the trustee shall distribute outright to such child the entire separate trust estate, including principal and undistributed income.

Paragraph 7(c) provides that if, however, such child shall die before the termination of the separate trust estate pursuant to paragraph 11 hereof, the trustee shall hold the then remaining principal and undistributed income in a separate trust or trusts for the benefit of the then living issue of such child in accordance with the provisions of paragraph 8 hereof. If no issue of such child are then living the trustee shall pay the remaining principal and undistributed income of the trust (i) to Daughter's then living issue *per stirpes*, or (ii) if Daughter has no issue then living, to the Settlor's then living issue *per stirpes*, or (iii) if the Settlor has no then living issue to the person or persons then living who would be entitled to inherit the Settlor's personal property under the laws of State then in force if the Settlor had then died intestate.

Paragraph 9 provides that paragraphs 3 through 8 shall apply to Trust B in such manner that (a) each reference to Daughter shall be read as a reference to Son, and (b) each reference to Trust A shall be read as a reference to Trust B.

Paragraph 10 provides that if at the time of any distribution from Trust A or Trust B or any separate trust estate under either of them (other than a distribution of income or of principal made in the trustee's discretion or a distribution made pursuant to paragraph 11 hereof), any person entitled to receive a share of such distribution is then a beneficiary of Trust A or Trust B or of any separate trust estate under either of them, the share of such beneficiary shall be added to the principal of Trust A or Trust B or of the separate trust estate, as the case may be, as an integral part thereof, to be held, administered and distributed in accordance with all the terms, conditions and limitation applying thereto.

Paragraph 11 provides that unless sooner terminated pursuant to other provisions in Trust, then notwithstanding any other provisions of Trust, Trust A, Trust B and every separate trust estate under either of them shall terminate 21 years after the

death of the last survivor of Spouse, Son, Daughter, Grandson, and Granddaughters 1 and 2.

Settlor died on Date 2 (a date prior to September 25, 1985). Son died before Daughter, leaving no issue. Pursuant to Paragraphs 5 and 10 of Trust, the remaining principal and undistributed income of Trust B was distributed to Trust A.

On Date 3 (a date after September 25, 1985), Daughter died survived by her son and two daughters, Grandson and Granddaughters 1 and 2. Pursuant to Paragraph 6 of Trust, a trust was established for each of Daughter's surviving children, Grandson's Trust, Granddaughter 1's Trust, and Granddaughter 2's Trust. The trustee of Trust A and Trust B represents that there have been no additions, actual or constructive, to Trust, Grandson's Trust or Granddaughters' Trusts after September 25, 1985.

State Statute 2.a. provides:

Unless expressly prohibited by the terms of a trust, a fiduciary may release the power to make adjustments and convert to a unitrust as described in this subsection, if all of the following apply:

1. The fiduciary determines that the conversion will enable the fiduciary better to carry out the intent of the settlor or testator and the purposes of the trust;
2. The fiduciary gives written notice of the fiduciary's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the fiduciary will make under this subsection, to each beneficiary, by certified mail with restricted delivery and return receipt, who, on the date the notice is given:
 - a. Is a distributee or permissible distributee of trust income or principal; or
 - b. Would be a distributee or permissible distributee of trust principal if the interests of the distributees described in subparagraph 2.a. of this paragraph terminated and the trust then terminated immediately before the notice was given and if no powers of appointment were exercised;
3. There is at least one (1) beneficiary under subparagraph 2.a. of this paragraph and at least one (1) other reasonably ascertainable person who is a remainder beneficiary under subparagraph 2.b. of this paragraph; and

4. Every beneficiary to whom notice was sent pursuant to subparagraph 2. of this paragraph has received the notice as evidenced by the certified mail return receipt and no beneficiary objects to the conversion to a unitrust in a writing delivered to the fiduciary within thirty (30) days after the notice is given under subparagraph 2. of this paragraph.

State Statute 2.e. provides:

After a trust is converted to a unitrust, all of the following provisions shall apply:

1. The fiduciary shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:

- a. From appreciation of principal;
- b. From earnings and distributions from principal; or
- c. From both;

2. The fiduciary shall make regular distributions in accordance with the terms of the trust, or the terms of the will, as the case may be, construed in accordance with the provisions of this section; and

3. Unless expressly prohibited by the terms of the trust, the term "income" in the terms of a trust or will means an annual distribution, the "unitrust distribution," equal to the percentage, the "payout percentage," that is no less than three percent (3%) and no more than five percent (5%) and that the fiduciary may determine in the fiduciary's discretion from time to time, or, if the fiduciary makes no determination, that shall be four percent (4%), of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this chapter, averaged over the lesser of:

- a. The three (3) preceding years; or
- b. The period which the trust has been in existence.

The trustee proposes to convert Grandson's Trust and Granddaughters' Trusts to a total return unitrust pursuant to State Statute. Under the conversion, in each taxable year until the death of each grandchild, the trustee, in its uncontrolled discretion, would pay to, or apply for the benefit of, any one or more of the group consisting of such grandchild and such grandchild's issue who are living from time to time an amount or

amounts equal to 5 percent of the net fair market value of their respective trusts' assets valued as of the last business day of each of the immediately three preceding taxable years. Instead of seeking approval for the conversion in State court, the trustee intends to consummate the conversion using the consent procedures set forth in State Statute 2.a. upon receipt of a favorable private letter ruling.

The trustee has requested the following rulings:

(1) The conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) violate the transition rules under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and, thus, Trust, Grandson's Trust and Granddaughters' Trusts will continue to be exempt from the GST tax.

(2) The conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) cause Trust, Grandson's Trust and Granddaughters' Trusts or any of the beneficiaries to be subject to gift tax with respect thereto.

(3) The conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) be considered a sale, exchange or other disposition of property and will not cause Trust, Grandson's Trust, and Granddaughters' Trusts or any of the beneficiaries to realize a gain or loss for purposes of § 1001.

Law and Analysis - Rulings 1 and 2:

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual.

Section 2511(a) provides that the tax imposed by § 2501 will apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2601 imposes a tax on every GST. Section 2611(a) defines a GST as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions do not apply to any GST under a trust that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in

§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under § 2038 and § 2042.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Unless specifically noted, the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST or the creation of a new GST. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of the Income Tax

Regulations.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers a situation where in 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, *per stirpes*. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4 percent unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

The trustee represents that Trust was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to Trust (or any trust created under trust including Trust A, Trust B, Grandson's Trusts and Granddaughters' Trusts) after September 25, 1985. Consequently, Grandson's Trust and Granddaughters' Trusts are currently exempt from GST tax.

The facts in this case are similar to those set forth in Example 11 of § 26.2601-1(b)(4)(i)(E), which provides that the conversion of an income interest to a unitrust interest pursuant to state statute will not be considered to shift a beneficial interest in a trust for GST purposes. In addition, this example provides no trust beneficiary will be treated as having made a gift for federal gift tax purposes as a result of such a conversion.

Accordingly, based upon the facts submitted and the representations made and provided the proposed conversions meet the requirements of State Statute and other applicable State statutes, we conclude that the conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) violate the transition rules under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and, thus, Trust, Grandson's Trust, and Granddaughters' Trusts will continue to be exempt from the GST tax. We further conclude, based upon the facts submitted and

the representations made and provided the proposed conversions meet the requirements of State Statute and other applicable State statutes, that the conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) cause Trust, Grandson's Trust, and Granddaughters' Trusts or any of the beneficiaries to be subject to gift tax with respect thereto.

Ruling 3:

Section 61(a)(3) provides that, except as provided in subtitle A, gross income means all income from whatever source derived, including income from dealings in property.

Section 61(a)(15) provides that gross income includes income from an interest in a trust.

Section 1.61-1(a) provides that gross income means all income from whatever source derived, unless excluded by law. Gross income includes realized in any form, whether in money, property, or services.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized-- (1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

Section 1.1001-1(a) provides that, except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property differing materially in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." *Id.* At 565. In Cottage Savings, the Court held that mortgage loans made to different obligors and secured by different homes did embody

district legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. *Id.* At 566. In defining what constitutes a “material difference” for purposes of § 1001(a), the Court stated that properties are “different” in the sense that is material to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. *Id.* At 564-65.

Section 643(b) provides, in relevant part, that for purposes of this subpart and subparts B, C, and D, the term “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

Section 1.643-1(b) provides, in relevant part, that for purposes of subparts A through D, part I, subchapter J, chapter 1, “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of § 642(b) (relating to the personal exemption) and § 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

Section 1.643-1(b) further provides, in relevant part, that allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001 and will not result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries.

The trustee proposes to exercise the authority granted under State Statute to convert Grandson's Trust and Granddaughters' Trusts to a unitrust. Thus, the modification of the rights of the beneficiaries to the income and principal of their respective trusts as a result of the unitrust conversion is a result of the exercise by the trustee of authority granted to the trustee under the terms of Trust and State Statute, not as a result of the exchange of their interests in their respective trusts. Therefore, the proposed modifications of Grandson's Trust and Granddaughters' Trusts by mere exercise of the trustee's authority to make the conversions under a State Statute are not a sale or exchange of a materially different interest by any beneficiary.

Accordingly, based on the facts submitted and representations made and provided, the proposed conversions meet the requirements of State Statute and other applicable State statutes, we conclude that the conversion and the proposed trust distribution(s) will not (in the year in which the conversion is made and in any future tax years) be considered a sale, exchange or other disposition of property and will not cause Trust, Grandson's Trust and Granddaughters' Trusts or any of the beneficiaries to realize a gain or loss for purposes of § 1001.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer(s) and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Lorraine E. Gardner

Lorraine E. Gardner
Senior Counsel, Branch 4
(Passthroughs & Special Industries)

Enclosures:
Copy for section 6110 purposes

cc: